No. 84-1737

IN THE

SUPREME COURT OF THE UNITED STATES

UNITED STATES OF AMERICA,

Petitioner

v.

THE AMERICAN COLLEGE OF PHYSICIANS,

Respondent

On Writ of Certiorari to The United States Court of Appeals for the Federal Circuit

BRIEF FOR RESPONDENT

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Question Presented

The Internal Revenue Code imposes a tax on the income which a tax-exempt organization receives from trade or business activities that are not "substantially related" to the purposes or functions constituting the basis for its exemption, defined in the Treasury Regulations as activities that do not "contribute importantly" to its exempt purpose. The question presented is:

Whether income from advertisements in the scholarly journal of an exempt association of physicians, organized for charitable, scientific and educational purposes under section 501(c)(3) of the Code, is subject to the unrelated business income tax, where the advertisements relate solely to the practice of internal medicine, are uniquely informative, and are indisputably shown to contribute importantly to the association's exempt function of improving health care.

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BRIEF FOR RESPONDENT

STATEMENT

This action involves a claim for refund of federal income taxes paid by respondent The American College of Physicians, Inc. ("the College") on income received in 1973 from the publication of specialized advertising in its scientific journal, *Annals of Internal Medicine* ("*Annals*"). The issue is whether the advertising in *Annals* is "substantially related," *i.e.*, "contributes importantly," to the charitable, educational and scientific purposes constituting the basis for the College's exemption. Resolution of that issue requires consideration of (a) the exempt functions or purposes of the College, (b) the advertising activity in question, and (c) the contribution of the advertising activity to the exempt functions.

A. The purposes and functions underlying the College's exemption under section 501(c)(3).

The College is a membership corporation exempt pursuant to section 501(c)(3) of the Internal Revenue Code (the "Code"), which covers entities organized and operated exclusively for charitable, scientific, and kindred purposes (J.A. 16a).[1] The College's tax-exempt purposes are, *inter alia*, (1) to foster measures for the prevention of disease and for the improvement of public health; (2) to encourage research, especially in clinical medicine; and (3) to uphold and to maintain high standards in medical education and medical practice (J.A. 16a).

In furtherance of its exempt purposes, the College engages in a variety of activities directed to improving health care by physicians by sponsoring an annual comprehensive postgraduate session, other international and regional educational programs, and continuing education for member physicians (J.A. 21a). The College also sponsors a public education program on health-related issues, develops self-assessment examinations for its members, sets standards for internal medicine training programs, assesses tests and procedures used by practitioners, and comments on matters of public policy affecting internal medicine (J.A. 21a-24a). As part of these efforts, since 1927 the College has published *Annals*, which contains scholarly articles relevant to internal medicine and is generally considered the preeminent medical journal in that field (J.A. 17a, 22a, 38a).

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1. Section 501(c)(3) confers tax-exempt status on

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals . . . .

Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954, as amended. Unless otherwise specified, all references to the Code and the regulations promulgated thereunder are to provisions that were in effect in 1975.

B. The uniquely informative nature of the advertising in *Annals*.

Each monthly issue of *Annals* contains limited advertising which is relevant to the practice of internal medicine (J.A. 17a). The vast majority[2] are specialized ads for prescription drugs (J.A. 17a).[3]

Prescription drug ads are unique in that they are directed only at physicians, who occupy a legally acknowledged role as "learned intermediaries,"[4] rather than to the ultimate consumer,[5] and their content is largely mandated by the government. In 1962 Congress enacted legislation regulating the content of prescription drug ads and authorizing the Food & Drug Administration ("FDA") to mandate the information required to be included. 21 U.S.C. § 352(n). In 1963 FDA adopted generalized implementing regulations. 28 Fed. Reg. 6376 (1963). Effective in 1968, FDA promulgated more extensive regulations specifying the required and prohibited editorial content of prescription drug ads, involving, *inter alia*, prior FDA approval (mandatory in some circumstances, voluntary in others) and "true" and "fairly balanced" statements about such matters as side effects and contraindications. *See* 33 Fed. Reg. 9393 (1968) (now codified as amended at 21 C.F.R. § 202.1 (1985)). The government has described these as "the most stringent adver-

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2. *See, e.g.*, Exh. P-1 (January 1975 issue of *Annals*) (J.A. 45a); Respondent's Brief in Opposition to Petition for Writ of Certiorari p. 4 n.4.

3. The advertisements are concentrated (or "stacked") in two sections to the front and rear of the editorial copy, and are indexed (J.A. 17a). This stacking permits the physician to review all of the ads in a convenient location, and also avoids having the articles interrupted by ads which may not relate directly to them. The College sets the rates charged for advertising in *Annals* by reference to its publication costs, at a level comparable to rates set by other medical journals (J.A. 18a).

4. *See, e.g., Reyes v. Wyeth Labs.*, 498 F.2d 1264, 1276 (5th Cir.), *cert. denied*, 419 U.S. 1096 (1974).

5. The longstanding practice of not directing prescription drug advertising to consumers has been reinforced by a voluntary "moratorium" on such advertising imposed at the request of the FDA. Food Drug Cosm. L. Rep. (CCH) ¶ 42,879 (1983).

tising regulations for any product in commerce. . . . Every single advertisement for every FDA-approved drug is reviewed not only for the words it contains, but for its overall impact."[6]

The College maintains a strict policy, predating the FDA requirements,[7] of screening each proferred advertisement for accuracy and relevance to internal medicine, and has rejected advertisements of products which do not conform to its guidelines (J.A. 17a, 32a-33a).

C. The substantial importance of prescription drug advertising to the improvement of health care

For practitioners of internal medicine, advertising for prescription drugs in medical journals such as *Annals* has long been recognized as playing a crucially important role. This role was documented at trial by the uncontradicted testimony of Drs. Robert Moser, Edward Rosenow, Louis Lasagna and Stuart Bondurant.

Dr. Moser, formerly Chief of Medicine at Walter Reed Medical Center, a practicing internist, and currently Executive Vice President and a Fellow of the College, testified that the primary function of the College "is medical education of internists" with "the ultimate bottom-line hope . . . that this will provide better patient care [through] the efforts of these internists" (J.A. 20a). Dr. Moser (and the other expert witnesses) testified that the specialized limited product advertising carried in *Annals* was essential toward attaining this result by providing an efficient means of disseminating information concerning drugs and treatments to practicing physicians (J.A. 26a-28a). Dr. Moser characterized the advertising in *Annals* as "basically from

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6. Letter of Arthur Hull Hayes, Commissioner of Food & Drugs, to Rep. John P. Dingell, May 19, 1982. A sample ad is appended to the College's Brief in Opposition to the Petition.

7. Prior to the FDA requirements, the College maintained a body of volunteer physicians whose function was to check proffered ads for medical accuracy and thoroughness (J.A. 32a-33a).

pharmaceutical companies that . . . recently had a new drug released by FDA and want to let the profession know very quickly that the drug is now available" (J.A. 26a). Additionally, he testified that drug advertising was common when FDA approved a new indication for an already established drug (J.A. 26a).[8] As for both categories, Dr. Moser reiterated the College's position toward the inclusion of advertising expressed in a July 1977 editorial in *Annals*:

> Drug advertisements in peer-review journals are a vital part of continuing pharmacologic education. Since the Food and Drug Administration has imposed guidelines that limit advertising copy to content that does not extend beyond package-insert information, "truth in advertising" is not an issue . . . .
>
> No one, including the advertisers, expects that any good clinician will leap up and dash off reams of prescriptions on the basis of an appealing advertisement. But it does serve an alerting function: to provoke the physician's interest to the extent that he will look further into the drug's use by reading a contemporary pharmacologic text, or ask his librarian to reproduce a few references from current journals, or look it up in *The Medical Letter* or *AMA Drug Evaluations*. This

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8. The government notes that a few of the ads in *Annals* in 1975 were for "well-known and established products" like Insulin and Maalox, a fact said to undermine the proposition that one purpose of such ads was to alert readers to new developments (Gov't Br. 6). The government failed at trial to establish what it seeks in this Court to imply, i.e., that there had been no pertinent developments concerning such products. In fact, both of these products had undergone significant changes which extended their benefits to more potential users. During 1973, for example, U-100 Insulin was introduced, a single concentration suitable for most insulin-dependent diabetics. The new concentration was expected to completely replace pre-existing forms of the drug and to reduce the frequency of mistakes in dosage resulting from patient error. During 1975, Maalox introduced a new formulation which made it palatable to more antacid users. *See* 78 *Annals of Internal Medicine* No. 2, pp. 33-34 (1973); 82 *Annals of Internal Medicine* No. 5, pp. 86-87.

> catching of the reader's attention is a short but important step down the trail of education on drug use to more enlightened prescribing habits. [J.A. 26a-27a, 59a-60a].[9]

He characterized the alerting function of the ads in *Annals* as "most valuable." (J.A. 28a).

Dr. Rosenow, a Fellow of the College who was its Executive Director in 1975,[10] testified that "the half-life of medical knowledge is about five or six years," creating a pressing need for an accurate means to update and expand the knowledge of the College's member physicians (J.A. 34a). He said that a survey of the College's members concerning inclusion of ads in *Annals* had resulted in a "very strong and positive reaction;" members found the ads "very informational and educational" (J.A. 33a-34a).

Dr. Lasagna[11] confirmed that, particularly in the areas of available drugs and diagnostic procedures, the knowledge acquired during a physician's formal education became "increasingly out of date as the years went by" (J.A. 37a). Dr. Lasagna attributed this state of affairs to advances in new drug development, changes made over time in dosage forms and strengths of existing drugs, and additional indications and contraindications discovered in approved drugs after widespread use (J.A. 37a). Dr. Lasagna testified that drug advertising such as that carried in *Annals* was essential to disseminate information concerning all these developments (J.A. 38a). He characterized the editorial and advertising segments of *Annals* as being in a

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9. Toward this end, during 1975 the College published notices in *Annals* specifically requesting its readers to study the advertising as a means of keeping abreast of recent medical developments (Exh. P-4, at I-110).

10. Following his training at Harvard Medical School and the Mayo Clinic, Dr. Rosenow practiced internal medicine for nearly 20 years and then was a clinical professor at the University of Southern California and the University of Pennsylvania (J.A. 31a).

11. At the time of trial, Dr. Lasagna was Professor of Pharmacology and Medicine at the University of Rochester School of Medicine. Prior to that, he served as chairman of that department, and previously as organizer and head of the Division of Clinical Pharmacology at Johns Hopkins School of Medicine (J.A. 36a-37a).

"point-counterpoint relationship" and "interacting in an important way in trying to keep doctors up-to-date." He had "no doubt" that they "contribut[ed] importantly to keeping the doctors up to date" (J.A. 38a).

Dr. Bondurant[12] testified that medical education, rather than seeking to impart a fixed body of knowledge, is directed at equipping physicians for the continuous acquisition and critical appraisal of new information over a lifetime of practice (J.A. 42a). Particularly important to him was the internist's need for up-to-date knowledge of developments in the treatment of diseases through drugs (J.A. 43a). Dr. Bondurant restated the important and non-redundant role of drug and medical product advertising in fulfilling this need, and testified that medical training encouraged students to review ads contained in journals such as *Annals* (J.A. 43a-44a).[13]

D. The College's first successful challenge to IRS' attempt to tax its advertising income.

After paying taxes on its advertising income in 1968 and 1969, the College sought a refund in the Court of Claims, arguing that regulations of the Internal Revenue Service ("IRS") adopted in 1967, which required the "fragmentation" of its publishing activities into editorial matter and advertising, each to be treated separately for purposes of determining whether it was "related" (*see* p. 18 *infra*), were invalid as beyond the scope of the Code provisions they purported to implement. The Court of Claims agreed. *American College of Physicians v. United States*,

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12. Dr. Bondurant is Dean of the School of Medicine of the University of North Carolina at Chapel Hill. Prior to assuming that position, he served as president and dean of Albany Medical Center, chairman of the Department of Medicine at Albany Medical College, and as a professor at the University of Indiana School of Medicine (J.A. 41a). He is also a past Vice President and President of the College (J.A. 42a).

13. FDA regards prescription drug ads as constituting "post-graduate education." Address by FDA Commissioner James L. Goddard, Advertising and Government Relations Conference, Washington, D.C., Feb. 8, 1967, in Food Drug Cosm. L. Rep. (CCH) ¶ 80,161 (1967).

530 F.2d 930 (Ct. Cl. 1976) ("*ACP I*"); *accord*, *Massachusetts Medical Society v. United States*, 514 F.2d 153 (1st Cir. 1975).

On the premise that advertising could be fragmented from its editorial context, in *ACP I* the government argued (as it does here) that Example 7 of the regulations embodied a *per se* rule which made it unnecessary to resolve the factual dispute about whether the advertising in *Annals* contributed importantly to the College's exempt purposes so as to be "substantially related" thereto. (Trial Brief of the United States pp. 13-14). In that case the College responded, as here, that any *per se* rule in Example 7 was confined to organizations exempt pursuant to section 501(c)(6),[14] to which Example 7 specifically refers, and that, even if there could be fragmentation, the case presented a factual issue as to whether the ads contributed importantly to the College's exempt purposes. Accordingly, the College submitted affidavits showing, *inter alia*, that the advertising in *Annals* constituted an "abbreviated medical textbook article on the specific drug" advertised, and hence contributed importantly to the College's exempt purposes under section 501(c)(3); the government offered affidavits to the contrary. 530 F.2d at 931 n.3.

Finding dispositive its decision that the "fragmentation" regulation was invalid "irrespective of whether the advertisements themselves are or are not substantially related to plaintiff's exempt purpose," the Court of Claims agreed that if the ads could be fragmented the case would present an "essentially factual dispute" as to whether they were "related." *Id*. This characterization necessarily rejected the government's *per se* approach.[15]

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14. Exemption pursuant to section 501(c)(6) is granted to "[b]usiness leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual."

15. By the time *ACP I* was decided, Congress in 1969 had amended section 513(c) to endorse the concept of "fragmentation" in the 1967 regulations (see pp. 22-25 *infra*), yet the *ACP I* court obviously did not regard the regulations or Congress' action as establishing a *per se* rule.

E. The instant litigation.

For taxable year 1975, the College paid $55,965 in taxes on income from its publications, and thereafter sought a refund of those taxes (J.A. 16a). The College timely filed a petition for refund with the Claims Court, alleging, as it had in *ACP I*, that the advertising in *Annals* was "substantially related" to its exempt purposes, and therefore exempt from tax (J.A. 6a-9a).

In response to the College's testimony (see pp. 4-7 *supra*), the government conducted minimal cross examination and offered no rebuttal testimony. Nevertheless, the Claims Court concluded that the advertising in *Annals* was not "substantially related" to any exempt purpose of the College and thus was taxable (Pet. App. 30a). The trial court, while employing a factual analysis and not a *per se* rule, concluded that the advertising had a predominantly commercial nature which precluded it from contributing importantly to the purposes underlying the College's exemption (Pet. App. 29a-30a).

On appeal, the United States Court of Appeals for the Federal Circuit reversed. In an opinion by Judge Edward Smith,[16] the court of appeals agreed, as both sides had argued, that the Claims Court had correctly viewed the issue as factual, but held that the trial court's resolution of the relatedness issue against the College was clearly erroneous for the undue weight given to the commercial aspects of the ads. The court of appeals held that the trial court had imposed too rigorous a standard, by placing "too great an emphasis on the similarity of the activity to commercial advertising" (Pet. App. 16a). The statute, the court held, provides that the determinative factor is the importance of the contribution of an activity to the performance of an organization's exempt functions, rather than the commercial character of the activity (Pet. App. 16a).

Reviewing the pertinent legislative history, the court of appeals found no basis in the statute for the proposition that Congress had declared that advertising in professional journals was

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16. Judge Smith is a former tax attorney both in private practice and in the Tax Division of the Justice Department.

unrelated. Rather, after analyzing the regulations, the court concluded that advertising, like every other activity, was subject to the factual analysis dictated by the statute and regulations to determine whether it was "substantially related" and "contributed importantly" to an exempt purpose (Pet. App. 12a-13a). It found that the advertising in *Annals* in fact contributed importantly to the College's exempt purposes under section 501(c)(3).

SUMMARY OF ARGUMENT

The government asks this Court to rewrite the tax laws to set forth a rule that Congress declined to adopt and which the Treasury has not provided in its regulations. Like the court of appeals, the Court should decline the invitation.

The ultimate issue in this case is whether the advertising in *Annals* is "substantially related" to the charitable, scientific, and educational purposes underlying the College's exemption as a public-service organization under section 501(c)(3) of the Code. The Code, the Treasury regulations, and a prior court decision involving the College all treat that question as presenting a "factual" dispute, as did the parties and both courts below in this case.

The undisputed record evidence, much of it through stipulation, demonstrates that the advertising in *Annals* relates exclusively to the practice of internal medicine, is predominantly for prescription drugs and hence by government mandate is uniquely informative, contributes importantly to the improvement of health care through the continuing professional education of physicians, and is substantially related to its exempt purposes. When the government failed to controvert the College's testimony, it in effect conceded that the advertising in *Annals* does "contribute importantly" to exempt functions of the College. The government now asks this Court to disregard this relevant record evidence, asserts there is no need for a factual analysis, and urges a vaguely framed conclusive presumption or *per se* rule that cannot be founded in the statute, the regulations, nor the case law.

Since its enactment in 1950, section 513(a) has required analysis of whether an activity is "substantially related" to the purposes underlying an organization's exemption. Treasury regulations adopted in 1958 and amended in 1967 emphasize that relatedness depends on the "facts and circumstances" in "each case." The need for a case-by-case factual approach was not altered by the 1969 amendment to section 513(c). Although Congress considered whether to enact a *per se* rule that journal advertising was unrelated, it did not do so, and instead left unchanged the "substantially related" standard of section 513(a) and the case-by-case factual approach of the regulations. The only action Congress took was to permit fragmentation of a "business" into multiple activities (e.g., treating advertising and editorial matter in a journal separately) so that each would be tested independently as to whether it "contributes importantly" to the organization's exempt purposes.

Since the 1969 Act did not change the definition of "substantially related," the 1969 legislative history concerning when advertising or other particular activities are "substantially related" under the 1950 act is of little value in applying section 513(a) in this case. The court of appeals properly found that history unpersuasive. It reveals not that Congress intended to tax all journal advertising or to endorse the government's reading of the regulations in this case, but rather merely to permit advertising and other activities to be treated separately. While such fragmentation might well result in advertising income being taxed in most cases, it still permits exemption based on the facts and circumstances in particular cases in which advertising activity is shown to contribute importantly to an exempt purpose or function of an organization. This is such a case.

The government's reliance upon Example 7 of the regulations as the source of a *per se* rule applicable in this case is misplaced. The substantive portion of the regulations does not purport to set forth any such rule. Example 7 concerns an organization whose exempt function is to promote industry objectives — a "mutual benefit" business league exempt under section 501(c)(6) rather than a "public service" charitable organization such as the College which the government stipulated to

be exempt under section 501(c)(3) — and such differences in function or purpose are material. Moreover, the stringently regulated, uniquely informative advertising for prescription drugs involved here is not akin to the "ordinary commercial advertising" in Example 7.

The court of appeals was not asked to and did not invalidate Example 7. Rather, it properly applied the regulations to the facts and circumstances established by the record in this case showing that the advertising in *Annals* contributes importantly to the College's exempt purposes. However, if Example 7 were construed as establishing a *per se* rule or conclusive presumption applicable in this case, it would be invalid as being contrary to the Code and inconsistent with the substantive provisions of the regulations. It should be applied no more broadly than the express limitations stated in the example to avoid raising questions of its validity, and the questions raised by application of Example 7 to business leagues or other organizations, however fascinating, should left for a case involving such an organization.

The government also argues that *Annals* competes with the publications of for-profit organizations. However, as the government has successfully established in other cases, the presence or absence of competition is irrelevant under the statute. The test is the relationship of the activity to the exempt functions of the organization.

Finally, there is no basis for the government's contention that the decision below sanctions unfair competition, imposes substantial costs, or requires a novel or burdensome case-by-case analysis. The statute and regulations have always required a case-by-case analysis of the facts and circumstances; few organizations are likely to be able to make such a strong showing that advertising in their journals contributes importantly to their exempt purposes; and there is no basis for apprehending unfair competition.

The government's theory is that the type of advertising, the nature of the exempt function, and proof of the ads' contribution thereto are essentially irrelevant. Such a test is not in the statute

or regulations and is not mandated by legislative history. The court of appeals properly rejected the government's theory and so should this Court.

ARGUMENT

I. Congress Did Not Enact or Endorse a *Per Se* Rule for Determining Whether Journal Advertising Has a "Substantial Relationship" to an Organization's Exempt Purpose.

The government, supported by *amicus* American Business Press ("ABP"), advocates in this Court a *per se* rule or conclusive presumption under which evidence that the advertising in *Annals* contributes importantly to the purposes underlying the College's exemption under section 501(c)(3) is irrelevant as a matter of law. It is easier to pick up mercury, however, than to grasp with certitude either the content or the source of the government's *per se* rule.

While this purported "rule" appears in many guises and is claimed to spring from many sources,[17] the government's favor-

17. For example, the government's statement of the question presented suggests a rule that "commercial advertising in the journal of a tax-exempt medical association" is unrelated business income (Gov't Br. i). Elsewhere, however, the government urges broader formulations to the effect that any income from commercial advertising in "publications of any tax-exempt organization" (*id.* at 15, 27, 29, 40 n.13, 41, 42, 43), or any income from "advertising" in such publications, is unrelated business income (*id.* at 9, 15, 25, 26, 28). At other times, it frames the rule more narrowly as applying only to "ordinary" commercial advertising (*id.* at 11), any "advertising business carried on by any exempt organization in competition with other taxpaying advertising business" (*id.* at 25), or "advertising 'designed and selected in the manner of ordinary commercial advertising' " (*id.* at 8, 10, 11, 18, 28, 30, 42).

As for the source of the rule, sometimes it is said to be rooted in the 1950 Revenue Act or its legislative history (*id.* at 11), while at other times the attributed provenance is either the 1967 Treasury regulations (*id.* at 8, 16-18, 27-28, 29, 32), the legislative history of the Tax Reform Act of 1969 (*id.* at 9, 18-26, 29, 32, 33), or a subsequent amendment to the regulations (*id.* at 4, 5, 26 n.7). Except for noting a cryptic reference to "advertising" in the heading of section 513(c) (Gov't Br. 4, 7, 9, 24), the government makes no effort to root its *per se* rule in the language of the Code itself, normally the prime evidence and embodiment of Congressional intent. The Code makes clear that heading references do not constitute substantive law. I.R.C. §7806(b).

ite formulation ("advertising 'designed and selected in the manner of ordinary commercial advertising' " is unrelated), is based on Example 7 of the 1967 regulations, although, significantly, it fails to embody all of the material factual elements of that example.[18] The government's difficulty in articulating and documenting precisely the *per se* rule it advocates reflects the rule's doubtful legitimacy. *Per se* rules or conclusive presumptions barring consideration of relevant evidence are disfavored, and will not ordinarily be inferred.[19] Here, examination of the statute, regulations, and pertinent legislative history demonstrates that the government's *per se* rule, in any of its manifestations, is simply untenable.

A. The 1950 Revenue Act did not tax income from advertising in professional journals.

The unrelated business income tax ("UBIT") was first enacted in the Revenue Act of 1950, ch. 994, § 301, 64 Stat. 906, 947, in response to widespread negative publicity over acquisitions of clearly unrelated businesses by exempt organizations in the 1940's. A prime example involved the transfer of the income of the Mueller macaroni company to New York University School of Law. *See C. F. Mueller Co. v. Commissioner*, 190 F.2d

18. It omits in particular the reference to an organization exempt under section 501(c)(6), to which alone Example 7 refers, and the requirement that the informational function of the ad be "incidental" and "differ in no essential respect from the informational function of any commercial advertising" (see pp. 19-20, 42, *infra*).

19. A regulation establishing a conclusive presumption should be even more vulnerable than a statute, as to which this Court has said: "Statutes creating permanent irrebuttable presumptions have long been disfavored under the Due Process Clauses of the Fifth and Fourteenth Amendments." *Vlandis v. Kline*, 412 U.S. 441, 446 (1973) (citing, *e.g.*, *Heiner v. Donnan*, 285 U.S. 312 (1932) (invalidating conclusive presumption in tax law). The rationale for such disfavor is that, when a statute provides that a person's rights or privileges are governed by the existence of specified factual circumstances, a conclusive presumption concerning the operative determinations contrary to fact, and preclusion of factual determinations contrary to the presumption, constitutes a denial of due process. *See, e.g., United States Dep't of Agriculture v. Murry*, 413 U.S. 508, 514 (1973).

120 (3d Cir. 1951). Under then-existing law, because the destination of the income was a tax-exempt organization, the company's income achieved tax-exempt status, even though the purchase was financed in part by a loan to be repaid by future profits and the source of the income was wholly unrelated to the university's exempt purposes.

In a message to Congress, President Truman proposed changes to the tax laws to address "the conduct of business and industrial operations *entirely unrelated* to educational activities." *Hearings on Revenue Revision of 1950 before the House Comm. on Ways and Means*, 81st Cong., 2d Sess. 4-5 (1950) (emphasis added). Similarly, then-Secretary of Treasury Snyder testified concerning what was to become section 513(a):

> Business operations of charitable and educational institutions *clearly unrelated* to their exempt functions generally would be subjected to the regular corporation income tax. This would apply to organizations now engaging in such unrelated business activities as the manufacture of food products, leather goods, vegetable oils, and the distribution of petroleum products.

Hearings on Revenue Revision of 1950 before the Senate Finance Comm., 81st Cong., 2d Sess. 6-7 (1950) (emphasis added). He noted that the bill would not tax income "from related activities, such as the operation of bookstores, dining halls, dormitories, or experimental farms, *customarily carried on* by educational and charitable organizations." *Id.* (emphasis added).[20]

This legislative history speaks of closing a perceived loophole which permitted tax-exempt institutions to acquire totally unrelated private businesses and imbue them with tax-exempt status. The examples cited involved businesses having virtually nothing to do with the organizations' exempt purposes.

In response, Congress enacted the UBIT, now set forth in sections 511 to 514 of the Code. Section 511(a) imposed a tax on an exempt organization's "unrelated business taxable income," defined by section 512(a)(1) as the gross income derived by any

20. *See also* S. Rep. No. 2375, 81st Cong., 2d Sess., 28-31 (1950).

organization (less allowable deductions) from (1) any "trade or business," (2) "regularly carried on" by it, (3) that is "unrelated." Of these three statutory elements, the "related" test in issue here[21] has been described as "the most difficult to apply," one that "necessarily examines both the content of an institution's exempt function . . . and the relationship of the activity in question to that exempt function." Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 Colum. L. Rev. 1430, 1450 (1980).[22]

Section 513(a), which since its enactment has not been amended, defines "unrelated" trade or business as including

> any trade or business the conduct of which is not *substantially related* (aside from the need of such organization for income or funds or the use it makes of the profits derived) *to the exercise or performance* by such organization of its charitable, educational, or other *purpose or function constituting the basis for its exemption* under section 501. [Emphasis added].

Despite references in the legislative history to unfair competition, this statutory scheme makes no reference to competition; by its terms, income from an "unrelated" trade or business is taxable even if there is no competition, while income from a "substantially related" trade or business is exempt no matter how intense or "unfair" the competition. *Louisiana Credit Union League v. United States*, 693 F.2d 525, 541-42 (5th Cir. 1982). The key is the "relatedness" of the trade or business to the organization's exempt purpose. Nothing in the language of the

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21. The College does not contest that its publication of advertising in *Annals* in 1975 was a "trade or business" as defined in section 513 or was "regularly carried on." Solely the "relatedness" of the advertising activity is at issue in this case.

22. *See also* Rose-Ackerman, *Unfair Competition & Corporate Income Taxation*, 34 Stan. L. Rev. 1017, 1018 (1982) ("Of course, the meaning of 'related' is not obvious and [IRS] and the courts have experienced predictable difficulties settling on a definition."); P. Treusch & N. Sugarman, *Tax Exempt Charitable Organizations*, 186-87 (1979).

statute or its history even remotely suggests that Congress intended that income from advertising in professional journals — which in 1950 was a well-established activity "customarily carried on" by exempt organizations[23] — was to be deemed unrelated and taxed generally or at all. Indeed, for the next 17 years the IRS did not seriously attempt to tax journal advertising income, and the College, like other exempt organizations, did not pay taxes on it. As the court stated in *ACP I*, "[t]he 1950 Act was a fairly limited measure, designed to distinguish the customary activities of exempt organizations from the operation of independent business enterprises entirely unrelated to the educational purpose of the organization." 530 F.2d at 933; *see also Massachusetts Medical Society v. United States*, *supra*, 514 F.2d at 155. There is simply no merit to any suggestion that the 1950 Act or its history supports any formulation of the government's *per se* rule.

B. The Treasury's interpretative regulations require analysis of the facts and circumstances of each case and do not purport to set forth any *per se* rule concerning journal advertising of organizations exempt under section 501(c)(3).

The first regulations to interpret sections 511 through 514 appeared in 1958 and made no attempt to tax journal advertising. The original regulations made clear that the analysis to be undertaken in determining whether there was a "substantial relationship" was factual, and that the decision whether or not the activity was taxable depended upon the "particular circumstances involved in each individual case." Treas. Reg. §1.513-1(a)(2) (1958).

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23. *ACP I*, 530 F.2d at 933. The College, for example, has included advertising in its journal since at least 1927. *E.g.*, 1 *Annals Of Internal Medicine* No. 2 (1927). References in unenacted bills in a prior Congress to unrelated publishing activities (ABP Br. 9-10) in no way indicate that Congress intended the 1950 Act to tax journal advertising.

In 1967, the Treasury published revised interpretive regulations which took steps to address the argument that "commercial advertisements arguably were part and parcel of a unified trade or business ('publishing') with an ultimately educational end" (Gov't Br. 13). These regulations for the first time "fragmented" the activities of a tax-exempt organization into individual components, stating that for purposes of ascertaining whether income was derived from a "trade or business," activities do not lose their identity because carried on within a larger complex of the organization's other endeavors. 32 Fed. Reg. 5993 (1967); *see* Treas. Reg. § 1.513-1(b). With particular respect to advertising, the regulations provide that "activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization." *Id.*

The regulations additionally define an activity "substantially related" to an organization's exempt purposes as one which "contribute[s] importantly to the accomplishment of those purposes." 32 Fed. Reg. 5994 (1967); *see* Treas. Reg. § 1.513-1(d)(2). They reiterate that

> [w]hether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in *each case* upon the *facts and circumstances* involved. [*Id.* (emphasis added).]

Following the foregoing "applicable principles" in the regulations, there appear several illustrative "examples." 32 Fed. Reg. 5995 (1967); *see* Treas. Reg. § 1.513-1(d)(4)(iv). Example 5 addresses advertising in publications of universities (typically exempt pursuant to section 501(c)(3)) and presents circumstances in which advertising income is deemed "substantially related to the university's exempt aims" and thus exempt from tax. *Id.* Example 6, as proposed, purported to apply to "Z," "an exempt trade organization" which published a monthly journal and received

income from publication therein of "general consumer advertising, including advertising of such products as soft drinks, automobiles, articles of apparel, and home appliances." The income received from this advertising was deemed to be taxable. *Id.*

Although neither the applicable principles nor the examples in the proposed regulations purported to set forth any general or *per se* rule relating to advertising, the IRS Technical Information Release which accompanied the proposed regulations indicated that, as a general rule, IRS did intend to consider advertising as unrelated activity. Technical Information Release No. 899, April 14, 1967, I.R.B. 1967-19, 43, ("TIR-899"), reprinted in 1967-7 Stand. Fed. Tax Rep. (CCH) ¶ 6557. Consequently, as the government acknowledges (Gov't Br. 16), the proposed regulations unleashed a storm of controversy concerning both the new fragmentation principle and the possibility that they might portend *per se* treatment by IRS of all advertising income.

Following the comment period, in the final regulations Treasury made no pertinent changes to the applicable principles, but did significantly change the examples. It revised Example 6 by replacing the general reference to "an exempt trade organization" with the narrower specific reference to "an association exempt under Section 501(c)(6), formed to advance the interests of a particular profession and drawing its membership from the members of that profession." Treas. Reg. § 1.513-1(d)(4) Example 6.

For the first time, Treasury also added Example 7, the major source of the government's espoused *per se* rule in this case. Example 7 adopts the facts of Example 6 as to the nature of "Z," but restricts the advertising in "Z's" journal to "products which are within the general area of professional interest of its members," which conform to "certain general standards of taste, fairness, and accuracy," and which are "designed and selected in the manner of ordinary commercial advertising." Example 7 further assumes that the informational content of the ads is "incidental to the controlling aim of stimulating demand for the advertised products." The example concludes that the advertising so described does not contribute importantly to the accomplishment of the (c)(6) organization's exempt purposes. Treas.

Reg. § 1.513-1(d)(4) Example 7. Although the government implies otherwise (Govt. Br. 8), Example 7 makes no reference to medical journals or prescription drug ads. The regulations were published in this changed and narrowed form in December, 1967 (32 Fed. Reg. 17,657), unaccompanied by any repetition of the broad statement that had accompanied the earlier proposal, a fact overlooked by the government in its reliance upon TIR-699 (Govt. Br. 15, 36).

The examples in the 1967 regulations have been criticized for being conclusory and providing little guidance.[24] Nevertheless, even with the narrowing of Examples 6 and 7 to (c)(6) organizations, the regulations have a major impact, for some of the magazines accounting for the largest volume of advertising revenue are published by (c)(6) organizations, such as *Nation's Business* (published by the Chamber of Commerce), while many of the publications of (c)(3) organizations containing a large volume of advertising do not readily satisfy the "contributes importantly" standard (*e.g.*, *National Geographic*). "The regulations, however, also recognize that in some limited cases income from advertising may be regarded as 'related' when found to 'contribute importantly' to the accomplishment of the exempt purpose." P. Treusch & N. Sugarman, *Tax Exempt Charitable Organizations*, 196 (1979).

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24. *See*, *e.g.*, Kaplan, *supra*, 80 Colum. L. Rev. at 1453 ("No precise guideline is given for determining when the activity's contributions have risen to the level of importance required, and probably none is possible. Consequently, the examples provided are often more conclusory than analytical."); *id.* at 1454 ("Of less help in understanding the application of the 'contributes importantly' standard are the illustrations that focus on an activity's content").

C. The Tax Reform Act of 1969 placed in the tax laws only the fragmentation principle of the 1967 regulations.

1. Introduction: the UBIT amendment had limited significance among the many larger issues addressed in the 1969 Act.

The controversy did not subside after publication of the 1967 regulations, particularly as to the "fragmentation" of a journal into editorial matter and advertising. The debate continued not only in academic commentary such as that cited by the government, but in Congress, resulting in amendment of section 513(c) of the Code in the Tax Reform Act of 1969. Unfortunately, the government's description of the legislative debate is seriously flawed, omitting, for example, any mention of the important conference report and the language of the Senate-passed bill, which differed significantly from the legislation enacted.

In assessing the history of the 1969 legislation, several points must be noted at the outset. One is that the bill was complex and long (H.R. 13270 was 368 pages), the amendment to section 513(c) was a relatively minor issue,[25] and the subjects covered by the bill were addressed in wide-ranging House and Senate hearings (totalling more than 12,000 pages) and lengthy committee reports (totalling more than 1000 pages). Not surprisingly in such a situation, different and at times contradictory items can be found buried in the massive legislative history, and courts must be particularly cautious in attributing to Congress an intent not firmly rooted in the statutory language.

Furthermore, the hearings before the House Ways and Means Committee which the government repeatedly cites preceded introduction of the House bill. They addressed no bill but merely a variety of broadly framed issues.[26] The issue pertinent

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25. The amendment of section 513(c) was not among the Ways & Means Committee's summary of the "principal provisions" of the bill concerning tax-exempt organizations. House Comm. on Ways & Means, 91st Cong., 1st Sess., *Revised Summary List and Brief Description of Provisions Contained in H.R. 13270*, 1 (Comm. print 1969).

26. Before the House bill was introduced, legislative proposals had run the gamut from wholesale deferral or rejection of the 1967 regulations to their

to the treatment of advertising was framed by the Committee at the outset as follows:

> whether advertising income should be characterized as unrelated in the case of magazines and other periodicals published by exempt organizations where the editorial matter of the publication is related to its exempt function.

Hearings on Tax Reform, 1969, before the House Comm. on Ways & Means, 91st Cong., 1st Sess. 6 (1969).[27] Had Congress adopted legislation embodying an affirmative answer to that question, there might be some basis for the government's claimed *per se* rule. It is evident from its language and history, however, that the legislation finally enacted in 1969 stopped far short of an unqualified affirmative answer to that question. In effect, Congress decided only to let advertising activity stand on its own two feet.

2. The statutory language ignored by the government does not support a *per se* theory

At the conclusion of the House hearings, Representative Mills, Chairman of the House Ways & Means Committee, introduced H.R. 13270, which was reported to the House the next day. The bill made no reference to the regulations, to what is "related," nor to any *per se* rule concerning advertising. Rather, it merely amended section 513(c) to provide that, for the purposes of section 513,

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NOTES *(Continued)*

wholesale endorsement, with a myriad of variations along the way. Legislative history involving unenacted bills in a prior Congress (*see* Govt. Br. 18-19, 36-37; ABP Br. 15-19) sheds no light on the question before the Court in this case (see p. 30 n.37 *infra*).

27. The issues raised by the regulations were of such marginal consequence in the larger context that, even after this question was posed by the Committee, the advertising issue was not on the list of amendments the Administration was seeking with respect to UBIT. *See, e.g., House Hearings*, pt. 14, at 5047-49, 5131-45, 5481-82, 5491, 5500, 5509.

> the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

H.R. 13270, 91st Cong., 1st Sess., § 121 (1969).

Thus, the bill merely incorporated the fragmentation principle set forth in the 1967 regulations to permit separate consideration of the relatedness of a journal's editorial and advertising activities (Treas. Reg. § 1.513-1(b)), and thus to permit but not require taxation of journal advertising. As the House Report explained:

> Therefore, for example, the advertising contained in a publication of an exempt organization *may* be subject to the tax under section 511 even though the editorial content of the publication may be related to the exempt purposes of the organization.

H.R. Rep. No. 413, 91st Cong., 1st Sess. , pt. 2, at 26 (1969) (emphasis added).

The proposed amendment met opposition in the Senate. After further extensive hearings reflecting a welter of views, the Senate Finance Committee reported out a version of the House bill containing a materially different version of the amendment to section 513(c). Criticizing the existing statutory basis for the regulations as being "sufficiently unclear that substantial litigation could result from [the 1967] regulations," the Committee believed that in some sense the regulations "should be placed in the tax laws." S. Rep. No. 552, 91st Cong., 1st Sess., 75 (1969).[28]

28. The government seizes on this loose and not entirely accurate generalization as endorsement of its purported *per se* rule (e.g. Govt. Br. 9, 26, 27, 33). Of course, the sole portion of the regulations eventually "placed in the tax laws" was fragmentation. See p. 25 *infra*.

However, the Committee amendment (which the Senate adopted) differed from the House bill and the regulations in that it expressly declared only that advertising, pharmacies and horse races each constituted separate activities of an exempt organization.[29]

While more specific, this Senate-passed bill too addressed only the propriety of the fragmentation of activities; neither bill addressed whether or when a trade or business was "substantially related" within the meaning of section 513(a), a provision which was not amended in any respect by either bill.

The conferees did not entirely endorse either bill. They returned to the broader statement of fragmentation in the House bill, omitted the specific references to advertising, pharmacies, and horse racing in the Senate bill, and included fragmentation language common to both. The Conference Report, normally the most definitive commentary on legislation, provides no support for the government's position, referring only to the language of the bills concerning fragmentation and making no reference to the regulations, to any *per se* rule concerning what is "substantially related," nor to any other application of the fragmentation principle to advertising or to any other particular trade or business activity. H.R. Rep. No. 782, 91st Cong., 1st Sess., 292 (1969).

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29. As passed by the Senate, H.R. 13270 provided that, for purposes of section 513,

> the term 'trade or business' includes the following activities carried on for the production of income:
>
> (1) the publication of advertising in any magazine, newspaper, periodical, or other publication, or the dissemination of advertising by radio or television broadcasts,
>
> (2) the conduct of a pharmacy, and
>
> (3) the conduct of horse races.
>
> For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

In a case involving the application of the "relatedness" test to income from a hospital pharmacy, one of the activities targeted with advertising for fragmentation in the Senate bill, the Fifth Circuit, after consideration of all of the pertinent legislative history, aptly described the final bill as rejecting the Senate bill's "mechanical" approach to fragmentation for the "more general approach" of the House bill, under which the issue of relatedness was still a "remaining question" not resolved by the legislation. *Hi-Plains Hospital v. United States*, 670 F.2d 528, 532 (5th Cir. 1982) (*see* p. ____*infra*).

Despite the heated debate described in the briefs of the government and ABP, therefore, the plain fact is that Congress did not, as it easily might have, enact *per se* taxation of journal advertising. Instead, it unambiguously codified only the principle that an exempt organization's business activities could be fragmented into their separate components, each of which must be tested and taxed according to the standard of section 513(a). "[T]he statute does not pretend to say whether or when [advertising] is 'unrelated' to the organization's exempt function." Treusch & Sugarman, *supra*, at 196.

Finding no support in the statutory language,[30] the government is forced to try to divine a Congressional intent in the tea leaves of legislative history. When the terms of a statute are unambiguous, however, they are conclusive, and legislative history need not be resorted to except in rare and exceptional circumstances. *United States v. Clark*, 454 U.S. 555, 560 (1982); *Howe v. Smith*, 452 U.S. 473, 483 (1981). *See also Louisiana Credit Union League v. United States*, *supra*, 693 F.2d at 541. The plain words of section 513 do not permit or require such resort here.

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30. The government inaccurately describes the 1969 amendment as "expressly sanctioning 'fragmentation' of an activity into exempt purpose and unrelated business components" (Govt. Br. 24). Under the amendment, each of the fragmented activities or components could still be shown to be "related." Since the government's *per se* rule cannot be founded in the language of the statute, the only other potentially proper source for it is the regulations. As we demonstrate below, however, the regulations also cannot properly be read as establishing such a rule (*see* pp. 33-46, *infra*).

3. The committee reports relied on by the government do not endorse a *per se* theory governing this case

The government's case is bottomed upon wholesale "legislation by committee report." At the heart of its argument are the statements in the House report that the regulations mainly affected medical journal advertising, and that "Your Committee . . . has concluded that advertising in a journal published by an exempt organization is not related to the organization's exempt functions." H.R. Rep. No. 413, *supra*, pt. 1, at 50. However, those statements were not reiterated in the Senate report, the Conference report, nor, more importantly, in the legislation enacted.

Moreover, this statement in the House report relating to the application of the regulations to the "substantially related" element of section 513(a) — more broadly framed than even Example 7 of the regulations (to which no report referred) — cannot properly be viewed as any more than an indication that, *in general*, exempt organizations would not readily be able to demonstrate that the advertising in their journals contributes importantly to their exempt purposes.[31] If the Committee also expressed overall agreement with the regulations, it necessarily endorsed the governing principle that whether *any* trade or business contributes importantly will depend upon the "facts and circumstances" of "each case." It is not plausible that, having endorsed that principle, the Committee was purporting to make a categorical factual determination applicable in all cases which would bind IRS and the courts in applying the regulations and section 513 as amended.

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31. The government errs in reading the House report as endorsing the regulations *in toto* and as categorically determining how they apply to advertising income from publications. The pertinent discussion relied on by the government is introduced by "In general," and further states that "it is anticipated" that advertising income will constitute unrelated business income (H.R. Rep. No. 413, *supra*, pt. 1, at 50). Reference to the "anticipated" result of applying the facts and circumstances test "in general" to advertising is not consistent with mandating a *per se* rule requiring that result.

In other respects, the committee reports reflect little more than approval of the regulations in a *general* sense, not necessarily all of their particular provisions. As the court of appeals aptly noted, "[t]he legislative history addresses advertising generally and does not grapple with specific factual situations" (Pet. App. 13a).

4. The statements in hearings relied on by the government provide no reliable evidence of Congressional intent

The other principal category of legislative history relied upon as authority for the government's *per se* rule consists of scattered statements made in the voluminous House committee hearings, mostly by opponents of the 1967 regulations before there was any specific bill to address (Gov't Br. 19-22; *see* ABP Br. 19-24).[32] However, "[r]emarks of this kind made in the course of legislative debate or hearings other than by persons responsible for the preparation or the drafting of a bill, are entitled to little weight. . . . This is especially so with regard to the statements of legislative opponents who '[i]n their zeal to defeat a bill . . . understandably tend to overstate its reach.'" *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203-04 n.24 (1976) (citations omitted).

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32. The government and ABP stress certain testimony in the House hearings by then-Executive Director of the College, Dr. Rosenow, concerning the 1967 regulations. In addition to explaining how the advertising in *Annals* was in fact "substantially related" to the College's exempt purposes, Dr. Rosenow — a physician and not a tax lawyer — expressed his concern that the regulations might be deemed to have the effect of conclusively presuming that advertising income from the College's publication was taxable. *House Hearings* 1113-14. Agencies and other litigants frequently, after further consideration, ultimately take a position different from their initial stance concerning the proper interpretation of a law or regulation. *See, e.g., Automobile Club v. Commissioner*, 353 U.S. 180 (1957) (Court sustained IRS' retroactive reversal of position concerning interpretation of law governing exempt status). Familiar with often hyperbolic advocacy presentations, Congress could not be expected to base its understanding of the regulations on the characterization by opponents of them.

The government and ABP point out that the hearings on the 1969 legislation, like the history of the 1950 Act, contain references to "unfair competition" (Gov. Br. 23; ABP Br. 4-6, 22-25). As Professor Bittker has noted, however, the legislative history of the UBIT reveals no analysis of such assertions of "unfair competition," which he terms "overstated if not wholly erroneous." B. Bittker & G. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 Yale L.J. 299, 319 (1976).[33] Moreover, as the court noted in *Louisiana Credit Union League v. United States*, *supra*, in interpreting the definition of a "trade or business" in section 513, "[a]lthough the legislative history speaks of competition, those who actually drafted the statute avoided the word as if it were the plague." 693 F.2d at 541. The UBIT "lacks a consistent economic underpinning. Rather it is a political compromise . . ." Kaplan, *supra*, 80 Colum. L. Rev. at 1466, 1471. In short, the vaguely expressed concerns about competition provide no statutory basis for determining whether in a particular case a trade or business is "substantially related" to an organization's exempt purposes.

The hearings reflected a variety of points of view concerning whether advertising in particular publications might be deemed to "contribute importantly" to the purposes underlying the exemptions of particular organizations. By giving general endorsement to the regulations, which mandate that the issue turns on the "facts and circumstances" of "each case," Congress wisely left

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33. In fact, one commentator recently concluded (a) that "nonprofits are no more likely to engage in predatory pricing than for-profits," (b) that it is problematic whether or to what extent there is any other problem of unfair competition, and (c) "that the present tax on nonprofits' 'unrelated' business income is exactly the wrong way to deal with the problem, generating more 'unfairness' than it has prevented. While an economically sophisticated definition of unfairness is possible, its application involves subtle empirical issues — so subtle that they may be beyond the administrative capacities of the IRS. As a consequence, outright repeal of the tax on unrelated business activities seems like the best policy response." Rose-Ackerman, *supra*, 34 Stan. L. Rev. at 1021-22, 1039.

resolution of those conflicting contentions to the application of the Code and the regulations in particular cases.

* * *

In sum, although the government repeatedly describes Congress as having "validated" the regulations and "placed them in the tax laws" (Gov't Br. 9, 25, 27), the only issue of validity identified by Congress was fragmentation, and that was the sole aspect of the regulations so "placed." In all other pertinent respects, the 1950 legislation and the regulations were unaffected by the 1969 Act. The government points only to Congressional statements in 1969 about how the provisions of section 513(a), enacted in 1950, should be construed, but such statements are entitled to no weight. "It is the intent of the Congress that enacted [the section] . . . that controls." *Oscar Mayer & Co. v. Evans*, 441 U.S. 750, 758 (1979) (citations omitted). The most that the legislative history suggests is that Congress intended as a *general* matter to endorse the principles incorporated in the 1967 regulations, primary among which was the "facts and circumstances" test. Congress did not analyze and endorse each and every word, and certainly not any particular applications of any illustrative example.[34]

In interpreting the intent of Congress in fashioning a compromise legislative solution, "the wisest course is to adhere closely to what Congress has written." *Rodriguez v. Compass Shipping Co.*, 451 U.S. 596, 617 (1981); *see also Mohasco Corp. v. Silver*, 447 U.S. 807, 826 (1980). If the Court's construction of Congress' intent "clashes with present legislative expectations, there is a simple remedy — the insertion of a brief appropriate phrase, by amendment, into the present language of §[513]. But it is for Congress, and not this Court, to enact the words that will

34. *See* Nomberg, IRS Tax Management Memorandum 76-12, p. 7 (June 7, 1976) ("The question of which advertising, if any, is related may be a fertile area for future litigation"); Liles & Blum, *Development of the Federal Tax Treatment of Charities*, 39 Law & Contemp. Probs. 6, 33 (Autumn 1975) (amendment "[left] unaffected the definition of 'unrelated'. Thus, exempt organizations can still argue . . . that certain kinds of advertising . . . are 'related' to the organization's exempt purposes").

produce the result the Government seeks in this case." *Bifulco v. United States*, 447 U.S. 381, 401 (1980).[35]

D. The 1971 amendment to the regulations provides no support for the government's per se rule.

As support for its *per se* rule, the government repeatedly cites section 1.512(a)-1(f) of the regulations, which contains a broad statement that, under section 513 of the Code and section 1.513-1 of the regulations, "*[i]n general* . . . amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business" (Gov't Br. 4, 5, 26 n.7) (emphasis added). That provision, promulgated in 1971, obviously cannot be said to have been endorsed by Congress in the 1969 Act. Moreover, the statement by its terms is a loosely phrased generalization introducing the subject matter of that section — the allocation of income and expenses between advertising and editorial content in cases where one is taxable and the other is not. Indeed, in its unqualified breadth, the statement is inconsistent with section 513(a) (e.g., activities for the convenience of members)[36] and the cited regulations (*e.g.*, Example 5). In short, this superfluous introductory language cannot be the basis for a *per se* rule if, as is the case, such a rule cannot be grounded in the 1967 regulations or the 1969 amendments.[37]

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35. Curiously, in view of the claimed significance of the decision below, the government did not include amendment of UBIT among the Administration's extensive recommmendations for revisions of the tax laws. *The President's Tax Proposals to the Congress for Fairness, Growth & Simplicity, May 29, 1985 (1985)*.

36. *See* p. 40 n.47 *infra*.

37. Forced to seek post-enactment evidence of the intent of Congress in the 1969 amendments, ABP notes that in several later Congresses bills concerning advertising income were introduced but that the bills were neither enacted nor the subject of hearings (ABP Br. 6). Unenacted bills, however, have no value as evidence of Congressional intent. *E.g., Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 381-82 n.11 (1969); *FTC v. Dean Foods Co.*, 384 U.S. 597, 609-10 (1966). This is particularly so here, where the later bill would only have amended section 512 to modify the computation of taxable income from unrelated advertising. *E.g.*, H.R. 990, 96th Cong., 1st Sess. § 8 (1979).

II. The Court of Appeals Properly Looked to the Facts and Circumstances Rather than Apply a Per Se Rule.

Despite the government's insistence here upon a *per se* rule, this case was litigated and decided throughout, in accordance with *ACP I*,[38] as requiring a factual inquiry based on an evidentiary record and an analysis of the relationship between the specialized drug advertising in *Annals* and the College's exempt section 501(c)(3) purposes. Inconsistently with its *per se* approach in this Court, the government neither moved for summary judgment nor objected at trial to the relevance of the College's uncontradicted evidence of the importance of the contribution of the advertising in *Annals* to its exempt purposes. Both courts below applied a factual analysis, not a *per se* approach. The Claims Court's factual analysis was overly restrictive, but nevertheless posited instances in which with slight variations in the facts the College's advertising activity could be deemed substantially related. The government itself on appeal took the position that "the Statute and Regulations require a factual inquiry into the activity, and its relationship to exempt functions," and, citing *ACP I*, that it "cannot be doubted that the question involved here is one of fact" (Brief for Appellee, pp. 3, 8-9).

The court of appeals was correct in agreeing with both parties and the trial court that the issue to be resolved was factual. *Accord*, *Hi-Plains Hospital v. United States*, *supra*, 670 F.2d at 531; *Professional Insurance Agents v. Commissioner*, 726 F.2d 1097, 1130 (6th Cir. 1984). Its refusal to overemphasize the commercial aspects of the College's advertising is equally consistent with prior authority. In *Hi-Plains Hospital*, *supra*, the Fifth Circuit determined that a hospital's revenues from the sale of drugs from its pharmacy directly to member physicians' private patients were exempt as substantially related to efforts by the hospital to attract and keep physicians in the region. The

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38. *See* 4 J. Rabkin & M. Johnson, *Federal Income, Gift & Estate Taxation* ¶ 59.02A(4), at 5919h (1982) (*ACP I*, "while involving only pre-1970 years, indicates that its holding might nevertheless apply for later years").

commercial character of the sales, as well as the inherent competition with "commercial" pharmacies, did not detract from the court's appropriate focus on the furtherance of the rural hospital's exempt goal of providing high-quality medical care to the community by attracting competent physicians.[39] Although the 1969 Senate bill had specifically enumerated sales from hospital pharmacies, together with advertising, in its categorical list of activities to be fragmented (*see* p. 24 & n.29, *supra*), the court's inquiry paralleled the analysis of the court of appeals in this case:

> While the rejection of the Senate version does not imply that sales by a hospital pharmacy to the general public were not within the ambit of section 513, it does indicate that the Congress rejected a mechanical application of section 513 to such sales in favor of a more general approach. Moreover, the purpose of this amendment was to identify particular activities as a trade or business within the meaning of section 513. *Such identification does not answer the remaining question of whether that activity is substantially related to the exempt purpose of the charitable organization*. [670 F.2d at 332 (emphasis added).]

The Fifth Circuit's factual analysis and its appraisal of the same legislative history pertinent to this case confirms the correctness

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39. Other rulings also disapprove of the use of commerciality or competition as the determinative factor in analyzing the "relatedness" of an activity. For example, Rev. Rul. 73-104, 1973-1 C.B. 263, holds that the sale of greeting card reproductions of works of art by a museum, at competitive prices, is tax-exempt. *See also* Rev. Rul. 69-267, 1969-1 C.B. 160 (income from sale of items in hospital gift shop exempt). The presence or absence of competitive aspects has certainly not been the determinative factor outside of the area of advertising. *See, e.g., Clarence LaBelle Post No. 217 v. United States*, 580 F.2d 270 (8th Cir.), *cert. dismissed*, 439 U.S. 1040 (1978) (bingo revenues held taxable even though there could be no commercial competition); Rev. Rul. 80-295, 80-296, 1980-2 C.B. 194, 195 (revenues from broadcast of intercollegiate athletics exempt).

of the decision of the court of appeals below.[40]

III. The Court of Appeals Did Not Invalidate Example 7 of the Regulations.

The government to the contrary, the court of appeals did not invalidate any portion of the regulations, implicitly or otherwise. Example 7 of the regulations does not establish a broad *per se* rule applicable to organizations exempt under section 501(c)(3) and, in any event, the record does not support the application of Example 7 to this case. If it were to be construed as a *per se* rule governing this case, Example 7 would be invalid as irrational and in conflict with the statute and regulations. As a prudential matter, therefore, this Court should construe the regulation so as to avoid raising questions concerning its validity.

A. Example 7 does not establish a broad per se rule

The government's favorite formulation of its espoused *per se* rule that all advertising income is taxable is based on Example 7 of the regulations. The government suggests that Example 7 establishes a "conclusive presumption" to the effect that, regardless of the category of organization or the nature of the product or service, advertising in a professional journal of an exempt organization cannot contribute importantly to the purposes underlying the organization's exemption. The government attacks the court of appeals' decision, which did not expressly address Example 7, as "invalidat[ing] sub silentio" a regulation explicitly endorsed by Congress (Gov't Br. 27-28). As discussed above, however, the sketchy and generalized legislative history and the eventual enactment of section 513(c) do not support a conclusion that Congress endorsed Example 7 as construed here by the government. The court of appeals' silence on Example 7 is more

40. Application of the "facts and circumstances" test is well illustrated by contrasting the result in *Hi-Plains Hospital* with that in *Carle Foundation v. United States*, 611 F.2d 1192 (7th Cir. 1979), *cert. denied*, 449 U.S. 824 (1980). In the former case, the operation of a pharmacy by a (c)(3) hospital was found to contribute importantly and in the latter, where no evidence was presented as to the pharmacy's role in inducing physicians to staff the hospital, it was not.

easily explainable as reflecting its agreement with the College that Example 7 was not applicable to the College and so not controlling in this case.

To urge a *per se* rule based on Example 7, the government must ignore the patent inconsistency of such a rule with the basic principles espoused in the regulations and even with the other examples that illustrate those principles. The regulations contain generally "applicable principles" setting forth the rules for determining when income of an exempt organization is unrelated, including the principle that "each case" is to be determined on the basis of all the "facts and circumstances." Treas. Reg. § 1.513-1(d)(2). Example 7 is simply what its name states, one of seven "examples" of the case-by-case application required by the Code and regulations. A *per se* rule would normally be found in a discussion of "principles" rather than "examples," and the "examples" cannot be described as setting forth "rules" applying beyond their own particular facts. When an agency's interpretation or application of its own rules flies in the face of the language of the rules themselves, it cannot be accepted. *Shea v. Vialpando*, 416 U.S. 251, 262 n. 11 (1974); *Union of Concerned Scientists v. NRC*, 711 F.2d 370, 381 (D.C. Cir. 1983).

One result of the government's efforts to elevate Example 7 to a *per se* rule is its resulting necessity to recognize "exceptions" to that "rule" in order to accommodate other IRS rulings or examples in the regulations. The "chief" such exception is said to concern ads in a student-run newspaper at a college exempt under section 501(c)(3), addressed in Example 5 of the regulations (Gov't Br. 28-29 & n.10).[41] The government also acknowledges

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41. In attempting to belittle the pertinence of Example 5, the government asserts that the College regards Example 5 "as standing for the general proposition that advertising published by Section 501(c)(3) groups, as contrasted with advertising published by Section 501(c)(6) groups, is substantially related to educational purposes;" on this premise the government attributes to the College a theory under which "a Section 501(c)(3) group's *radio* advertising profits (Example 4) are taxable, while its *print* advertising profits (Example 7 supposedly being inapplicable) are not" (Gov't Br. 40 n.13). Neither contention is accurate. The College cites Example 5 as indicating merely that advertising

an exception, recognized by the IRS after the 1969 Act, for an ad in a publication of an organization exempt under section 501(c)(3) that contains no "message" but merely a list of corporate patrons (*id.*, citing Rev. Rul. 76-93, 1976-1 C.B. 1970, in which the IRS itself rejected a "conclusive" presumption approach and took into account the particular exempt nature of the organization).

This equivocation reflects the shakiness of the foundation upon which the government's *per se* rule is built. It is difficult to see any rational basis for treating an ad devoid of informational content as "contribut[ing] importantly" to the exempt purposes of a section 501(c)(3) organization, and yet to presume conclusively that uniquely informative ads, which indisputably provide an important contribution to those purposes as a factual matter, do not "contribute importantly" within the meaning of the regulations. Only in Alice's Wonderland might such results be justified.

B. Example 7 addresses only business leagues exempt under section 501(c)(6) and is not at issue in the present case.

By its own terms, Example 7 does not pertain to an organization like the College, exempt under section 501(c)(3). It purports to be limited to business leagues exempt under section 501(c)(6).

Organizations granted exemption by the IRS pursuant to section 501(c)(6) are business leagues, chambers of commerce, or similar organizations formed to advance the financial interests of the particular businesses from which their memberships are drawn (see p. 8 n.14 *supra*). "Trade associations are the most common instances of exempt 'business leagues,' along with professional groups like the American Bar Association and the American Medical Association." B. Bittker & G. Rahdert, *supra*,

published by a section 501(c)(3) organization *can* be found to contribute importantly and be substantially related to its exempt purposes under the applicable principles established in the regulations. Whether it does so in a particular case depends upon the relationship of the advertising (either its content or the process of obtaining and publishing it) to the exempt functions of the particular organization.

85 Yale L.J. at 355. The College, on the other hand, was stipulated to be exempt pursuant to section 501(c)(3) as a charitable, scientific, and educational organization.

The government argues nevertheless that Example 7 establishes a *per se* rule applicable to (c)(3) organizations. This argument can succeed only if the Treasury's deliberate narrowing of the reference to (c)(6) organizations in its final promulgation of the 1967 regulations was, as the government implies, meaningless or, as the government asserts, there really is no difference between charitable organizations and business leagues. Neither point is supportable.

1. Example 7 intentionally addressed an organization exempt under section 501(c)(6).

All words in a statute or regulation are assumed to have been used for a particular purpose, and to have their ordinary meaning. *Escondido Mutual Water Co. v. LaJolla, Rincon, San Pasqual, Pauma & Paula Bands of Mission Indians*, 466 U.S. 765 (1984); *National Insulation Transportation Committee v. ICC*, 683 F.2d 533 (D.C.Cir. 1982). Among the other five examples applying the principles established in section 1.513-1(d)(4) of the regulations, no specific designation was supplied where the example was intended to apply across the board to all exempt organizations (*see, e.g.*, Example 4). There are several score of "examples" in the regulations pertaining to the UBIT; some refer to organizations exempt under specific paragraphs in section 501(c), others generally refer to "exempt organizations," and the remainder refer specifically to a particular type of organization, such as a "hospital", "trade association", or "university." *See* Appendix A to this Brief. The government has no explanation for such distinctions, and contends that they are "accidental" and meaningless (Gov't Br. 45). Yet the IRS took the trouble to change Example 6 from its original reference to "exempt trade organizations" to the more limited and precise reference to a (c)(6) organization.

It was perfectly appropriate for Treasury to use specific categories of exempt organizations in the examples, because the

statute and the regulations necessarily require examination of the relationship of activity to purpose, and the same type of activity might well be substantially related to the exempt purpose of one organization but not to another having a different exempt purpose. The Court must presume that the narrowed reference in Examples 6 and 7 to a (c)(6) organization was advertent and meaningful.

2. Organizations exempt under sections 501(c)(3) and (c)(6) have materially different purposes and cannot be equated for purposes of section 513 and the regulations.

One of the more surprising aspects of the government's position is the suggestion that there really is no material difference between organizations exempt under sections 501(c)(3) and (c)(6) (Gov't Br. 33-40), and that the reference in Example 7 to a (c)(6) organization should be read as encompassing both categories. The government asserts that exempt organizations "can generally choose to be organized under either" provision, and if Example 7 does not apply to a (c)(3) organization the payment of tax on advertising income would be "elective" (*id.* at 39). The government further suggests that in no instance has IRS (or anyone else) distinguished between organizations exempt under sections 501(c)(3) and (c)(6) for purposes of determining whether advertising is "substantially related," a distinction the government's brief calls "utterly unprecedented" (Gov't Br. 36).

In fact, however, only a few days before the government filed in this Court its reply memorandum in support of its Petition in this case, in which it first aired this suggested equivalence of (c)(3) and (c)(6) organizations (pp. 4-8), IRS itself issued a National Office Technical Advice Memorandum ruling stating that the decision of the court of appeals *in this case* does not apply to ads in publications of a business league exempt under (c)(6) because this case involved a (c)(3) organization. LTR

8538006 (June 17, 1985). [42] As IRS noted, the exempt purposes of a (c)(6) organization — to which the activity must contribute importantly — differ from those of a (c)(3).[43]

The same distinction was dispositive in *Louisiana Credit Union League v. United States*, *supra*, where the Fifth Circuit, distinguishing its earlier decision in *Hi-Plains Hospital*, reasoned that "because *Hi-Plains* dealt with a tax-exempt hospital rather than a business league, its analysis of the substantial relationship inquiry necessarily differs from that adopted here." 693 F.2d at 538 n.24. The hospital in question was a (c)(3) organization, while the credit union league was a (c)(6). The *Louisiana Credit* court found the League's tax-exempt function "a critical factor in the substantial relationship equation." *Id.* at 535. As a (c)(6) organization, the credit union league was directed to the common interest of its members in the improvement of business conditions, and the benefit of the members as a group rather than in their individual financial capacities. *Id.* Thus, any activity that did not generate inherently group benefits that accrued to its members in their capacities as members rather than individuals did not

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42. The College notes this ruling not as binding precedent but merely as evidence of IRS's analytical methodology in which the category of exempt organization is, quite properly, highly material in applying section 513. "[S]uch rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws." *Hanover Bank v. Commissioner*, 369 U.S. 672, 686-87 (1962).

43. The government below endorsed this approach before the court of appeals, stating:

> In any situation in which a determination must be made as to whether a particular business activity "contributes importantly" to the exempt function of an organization, the court must first clearly identify the purposes of the organization, and then carefully inquire into how one or more of those purposes is promoted by the business activity. *Since a business league is a different type of exempt organization, with a different kind of exempt function, analysis of how a business activity is directly related will naturally differ from the same inquiry involving a different organization, such as a hospital with different exempt functions.*

Brief for Appellee, p. 19 (emphasis added).

contribute importantly to the purposes underlying its exemption as a business league under (c)(6). *Id.* at 536. *Accord*, *Professional Insurance Agents v. Commissioner*, *supra*, 726 F.2d at 1103. [44]

In a case involving a (c)(6) organization, the government can argue, as it did in *Louisiana Credit*, that the advertising activity promotes the individual interests of members rather than their common interest in the advancement of industry objectives. Because a (c)(3) can serve charitable, scientific, or educational interests of individual members, not just group objectives, such a limitation is inapplicable in a case involving a (c)(3) organization such as the College.

The (c)(3) category of exemption is distinguishable from (c)(6) in several other significant respects. Because of their different purposes, organizations exempt under (c)(3) and (c)(6) have been identified by Professor Bittker as prime examples of two fundamentally different categories into which the 20-some categories of exempt organizations may be classified: "public service" organizations (including (c)(3)'s) and "mutual benefit" organizations (including (c)(6)'s). B. Bittker & G. Rahdert, *supra*, 85 Yale L.J. at 305.[45] "The promotion of health, like the relief of poverty and the advancement of education and religion, is one of

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44. In *American Bar Endowment v. United States*, 761 F.2d 1573 (Fed. Cir. 1985), *petition for cert. filed*, No. 85-599, income received by the Endowment, a section 501(c)(3) organization, from the furnishing of group insurance benefits for its members was held tax-exempt. In holding that the insurance/fundraising program at issue was not a "trade or business," the court distinguished the insurance program in *Louisiana Credit* primarily because it involved a (c)(6) business league rather than a (c)(3) charitable organization. The charitable purpose meant that a payment to a (c)(3) could properly be regarded as a charitable contribution, while a comparable payment to a (c)(6) business league was a business deduction. *Id.* at 1577. Relatedness was not in issue.

45. Professor Bittker describes "public service" organizations, such as charitable, educational, and scientific organizations, as those that assume part of the burden of government and the income of which is irrevocably dedicated to nonprofit purposes. 85 Yale L.J. at 332; *see Bob Jones University v. United States*, 461 U.S. 574, 587-88 (1983). By contrast, "mutual benefit" associations, such as business leagues, are not directed outward but are best viewed "as conduits through which the members pursue their own ends." 85 Yale L.J. at 306.

the purposes in the general law of charity that is deemed beneficial to the community as a whole. . . ." *Exempt Organization Handbook* ¶349.1(2), 4 Int. Rev. Manual (CCH) 20,583-5 (1982). Moreover, in addition to being the oldest category,[46] (c)(3) status entails both benefits and burdens not associated with other categories, such as business leagues exempt under (c)(6) with respect to UBIT[47] and other matters.[48]

The government contends, as *Louisana Credit* recognized, that some forms of educational activity may be a permissible means of furthering the mutual benefit purpose of a business league (Gov't Br. 35). However, education is not itself a statutory rationale for exemption of a business league under section

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46. The exemption for charitable, scientific and educational organizations dates from the Tariff Act of 1894, ch. 349, §32, 28 Stat. 509. Business leagues were not exempt until 1913. Revenue Act of 1913, ch. 16, §IIG(a), 38 Stat. 114.

47. Section 513(a) excludes from taxation any trade or business activity carried on by organizations exempt pursuant to a few of the 23 subsections of section 501(c), including (c)(3) but not (c)(6), "primarily for the convenience of" its members. Section 513(d), on the other hand, enacted in 1976, establishes a special limitation on the definition of "unrelated trade or business" for convention and trade show activities limited to (c)(5) (labor, agricultural, or horticultural) and (c)(6) organizations. Under this exemption, income from such organizations' exhibitions is deemed to be related if their purpose is the display of industry products, the stimulation of interest and demand for such products or services, or the education of persons engaged in the industry in the development of new products and services or new rules and regulations affecting the industry. I.R.C. §513(d)(3). This focus on industry objectives is consistent with not only the "mutual benefit" characterization recognized by Professor Bittker, but the regulations defining the exempt functions of business leagues and the methodology employed in *Louisiana Credit*. Prior to the 1976 legislation, IRS had issued a series of rulings concerning trade show income which had focussed on the "potential informational value" of the exhibits, as well as whether selling or order-taking occurred. Rev. Rul 75-516 through 75-520, 1975-2 C.B. 220-27. In view of the legislation, these rulings were recently revoked as obsolete. Rev. Rul. 85-123, 1985 I.R.B. 32, 8.

48. A (c)(3) organization may not engage in lobbying or other political activity permitted to a (c)(6). *See generally Regan v. Taxation with Representation*, 461 U.S. 540 (1983). Contributions to a (c)(3) organization are deductible, while contributions to a (c)(6) are not. I.R.C. §170. For a fuller discussion of the many distinctions between organizations exempt under (c)(3) and other exempt organizations, *see generally* Treusch & Sugarman, *supra*.

501(c)(6).[49] By contrast, educational, scientific, and charitable activities must be the *exclusive* purpose for which a (c)(3) organization is both organized and operated. *Cf. Better Business Bureau v. United States*, 326 U.S. 279, 283-85 (1945) (noting "unmistakable demarcation" between organizations exempt under (c)(3) and (c)(6)).

Because of the different roles of education of the members as a purpose underlying exemption under sections 501(c)(3) and (c)(6), the importance of the contribution to that purpose of the same educational activity (*e.g.*, publication of specialized advertising, even the same ads) can differ from one category of exempt organization to the other. Therefore, even if it is valid to presume that publication of professional interest advertising does not "contribute importantly" to the exempt purposes of a (c)(6) business league as described in Example 7, it does not logically or rationally follow that such advertising cannot contribute importantly to the exempt purposes of a (c)(3) organization. A decision affirming the court of appeals would not foreclose the application of Example 7 in an action involving a mutual benefit organization, since the difference in purposes is precisely one of the crucial "facts and circumstances" that the governing applicable principles of the regulations proclaim to be determinative.[50]

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49. The government relies upon *National Leather & Shoe Finders Ass'n v. Commissioner*, 9 T.C. 121 (1947), a decision in which IRS did not acquiesce, and where the court merely ruled that an organization was properly exempt under (c)(6). The provision of unspecified educational activities to further industry purposes was noted as one of the organization's activities, but was not the principal basis for its exemption.

50. The government argues that the College's emphasis on the differences in the purposes of organizations exempt under sections 501(c)(3) and (c)(6) represents a belated "shift[ing of] gears" first reflected in the College's pretrial brief (Gov't Br. 33). The government also contends that the College's argument that Example 7 should be limited (in accordance with its terms) to (c)(6) organizations has not been endorsed by any court (*id.* at 36). As we have noted (*see* p. 8, *supra*), in *ACP I* the College made the same contention, with the evident agreement of the Court of Claims in ruling that the issue was "essentially factual," and in this case the government endorsed that determination in *ACP I* in contending in the court of appeals that the issue in this case was "one of fact" (Brief for Appellee pp. 3, 8, 9).

Even if in some instances the question of whether an organization should be exempt under (c)(3) or (c)(6) may be difficult, once the decision is made, the consequences are numerous and important. In the instant case, the College is exempt under (c)(3) as a public service organization and it may not be treated as a "mutual benefit" business league exempt under (c)(6). The issue of the application of Example 7 properly awaits a (c)(6) case.

C. The record does not establish a basis for applying any *per se* rule in Example 7 to the College.

Aside from the fundamental differences between (c)(6) and (c)(3) organizations, there are additional ways in which the *per se* rule imputed to Example 7 is inapplicable to this case. The advertising described in Example 7 is materially different from the advertising published in *Annals*. Example 7 posits that the advertising is "designed and selected in the manner of ordinary commercial advertising," and that its informational function is "incidental" and "differs in no essential respect from the informational function of any commercial advertising." Here, the government argues that the informational function of the College's ads is "incidental" because it may have been secondary "to the purpose of raising revenues" (Gov't Br. 31-32). This confuses two distinct issues.

The evidence is undisputed that the content of the particular ads (mainly for prescription drugs) contributed importantly to significant charitable, scientific, and educational purposes of the College by assisting physicians in developing "more enlightened prescribing habits" (J.A. 59a-60a), in addition to producing income essential to other parts of the College's activities. This results from the unique nature of prescription drug ads, in which by government mandate the informational function *for the reader*, whose professional responsibility it is to prescribe the drug most effective in treating a particular patient (J.A. 59a-60a), is at least as important as the function for the advertiser of stim-

ulating demand (*see* pp. 3-4 *supra*).[51] Although the government repeatedly omits reference to this limitation in stating its *per se* rule, Example 7 is limited to ads having an informational function that "differs in no essential respect from the informational function of any commercial advertising." Treas. Reg. § 1.513-1(d)(4)(iv). Indeed, the government itself asserts that the "educational character" of the advertising is determinative (Gov't Br. 38-39), a test that requires consideration of the content of the ads and their informational value to the reader, not the advertiser's purpose.[52]

The record in this case is devoid of a factual basis for the application of a *per se* rule based on Example 7. In the trial court the government contended that all facts required for disposition of the case were set forth in the written stipulation of facts (Trial Br. of United States 2). That stipulation (J.A. 16a-18a) does not address the question whether the advertising in *Annals* was "designed and selected in the manner of ordinary commercial advertising." Nor was that evidentiary deficiency in the government's case cured by other evidence elicited at trial. The record addresses only the advertising in *Annals*, and not how other advertising is designed and selected.[53] The defects in the

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51. Indeed, because the government mandates the content and format of a major portion of the costly space devoted to prescription drug ads, it is fair to say that in substantial part such ads serve not the private commercial purposes of the advertiser, but rather a public purpose.

52. "[I]t is hard to understand how motive — particularly the advertiser's rather than the publisher's — can control whether the advertising in fact substantially forwards the exempt functions." Barlow, *The New Treasury Tax on Exempt Organization Advertising: A Postscript and a Preview*, in *Tax Problems of Non-Profit Organizations* 239, 256 (Webster ed. 1968). *See also* Liles & Blum, *supra*, 39 Law & Contemp. Prob. at 55 n.336.

53. The only evidence concerning advertising other than that in *Annals* established the irrelevant fact that "some" identical ads appeared in both *Annals* and medical journals published by non-exempt organizations (J.A. 18a). The record does not reveal to what extent this was the case, though it is not surprising in view of the pervasive regulation of the content and format of prescription drug ads. The government asserts that the Claims Court concluded, based on its findings concerning the similarity of some of the ads, that the College's ads "were 'designed and selected in the manner of ordinary commercial advertising' " (Gov't Br. 30, 31, citing Pet. App. 29a). The record does

evidentiary record cannot be cured in this Court by surmise or post-hoc argument by government counsel.

The stipulation also did not establish that the advertisements in question, primarily for prescription drugs, were "garden variety" (Govt. Br. 10) or "ordinary." To the contrary, the record makes clear that prescription drug ads are extraordinary in several pertinent respects. The undisputed testimony of the College's expert witnesses established that prescription drug advertising, which is uniquely informative in its content, plays a crucial role in the improvement of health care through continuing medical education, such that physicians are taught as a matter of good professional practice to review prescription drug ads (J.A. 26a, 44a) (*see* pp. 4-7, *supra*). Given these undisputed facts, if prescription drug advertising is "ordinary commercial advertising," that term has no meaning, for there is virtually no advertising which it would not embrace.

If the College's evidence was to be nullified by a *per se* rule, the government was obliged to establish the preconditions for applying the rule. This it failed to do.

D. If Example 7 establishes a *per se* rule applicable to this case, it is invalid.

If Example 7 should somehow be found applicable in this case, and to establish a *per se* rule deeming all advertising taxable, it should be invalidated as contrary to the Code and the remainder of the regulations. The government asserts that the regulations make "absolutely clear" that, regardless of the category of organization or exempt purpose, as a matter of law there can be no difference in the importance of the contribution to exempt purposes of any type of advertising, whether "general

NOTES (*Continued*)

not permit such a finding, unlike ordinary commercial advertising the content and design of prescription drug ads is largely mandated by the government, and the record addresses the manner of selection only with respect to *Annals*. Moreover, the Claims Court made no such finding or conclusion, but was merely discussing Example 7, to which the court saw some, but not necessarily a complete, "resemblance."

consumer advertising," "for products like soft drinks," or "professional interest advertising" "for products like drugs" (Gov't Br. 8). Whether or not such a *per se* rule or conclusive presumption would be valid if limited to (c)(6) business leagues — the only organizations to which Example 7 purports to apply[54] — it would be invalid if applicable in this case, involving a section 501(c)(3) organization that has shown that in fact the uniquely informative advertising in its journal contributes importantly to its exempt purposes.[55]

The government's position concerning the broad *per se* scope of Example 7 is fundamentally at odds with the regulation itself. The portion of the regulations setting forth the "applicable principles" (§ 1.513-1(d)) stresses the need in "each case" for careful examination of all the "facts and circumstances" in order to determine whether specific activities of an exempt organization "contribute importantly" to the particular purposes underlying that organization's exemption, and, if so, whether they are conducted on a larger scale than is reasonably necessary. The government's broad *per se* rule cannot be squared with that governing principle.

Beyond that basic inconsistency, the content of the government's broad *per se* rule is itself suspect if applicable to the College, for it lacks a rational basis: the manner in which advertising for a professional journal is designed and selected has no rational or discernible relationship to whether — in general or in a particular case — the same ads contribute importantly to

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54. Although the College has not challenged the validity of Example 7 if limited to (c)(6) organizations, serious questions are being raised by the amicus American Medical Association as to the invalidity of Example 7 even as to (c)(6) organizations. These questions lend further support to the arguments against finding Example 7 applicable in the instant case.

55. See pp. 2-7 *supra*. Because the Treasury regulations expressly call for individualized determinations based on the "facts and circumstances" of "each case," this is not a situation where Congress or the agency has concluded that "the difficulties of individual determinations outweigh the marginal increments in the precise effectuation of congressional concern which they might be expected to produce." *Weinberger v. Salfi*, 422 U.S. 749, 785 (1975).

the accomplishment of the exempt purpose of a (c)(3) organization. Nor is it discernible how the similarity *vel non* of such design and selection to the design and selection of "ordinary" commercial ads could determine the importance of the contribution of any type of advertising to the exempt purposes of any category of exempt organization.

While Treasury's interpetive regulations are due modest judicial deference where they are in accordance with their statutory underpinnings, they must be overturned where in conflict with the statute or otherwise in excess of legislative authority. *See Commissioner v. Engle*, 464 U.S. 206, 224-25 (1984); *American College of Physicians v. United States*, *supra*, 530 F.2d at 932; 5 U.S.C. § 706. So here, if interpreted to state a *per se* rule of taxation of advertising income applicable to the College, Example 7 must be invalidated.

To avoid having to address the questions that would be raised as to the validity of the regulation if requiring application of a conclusive presumption in this case, under customary prudential principles this Court ought to construe the regulation narrowly, as it is possible to do. *E.g., United States v. Grace*, 461 U.S. 171, 175-76 (1983); *Brockett v. Spokane Arcades, Inc.*, 105 S.Ct. 2794 (1985). For the same reason the Court must also examine with care the justification proffered for applying the government's *per se* presumption in this case.

IV. The Court of Appeals' Decision Does Not Sanction Unfair Competition, Impose Substantial Costs, Nor Require a Novel or Burdensome Case-By-Case Analysis.

The government's argument concludes with several policy contentions that seem irrelevant to the merits, but are in any event without merit. The government argues in this Court that the decision below will result in substantial revenue loss by opening a broad "loophole" for income from advertising in a wide range of professional and trade journals (*id.* at 41). Outside this Court, however, the IRS evidently regards the case as being

"narrow" in scope[56] and limited to (c)(3) organizations (*see* pp. 37-38, *supra*).

The government repeatedly asserts that the court of appeals' decision will impose some novel case-by-case approach to application of section 513 (*e.g.*, Gov't Br. 7, 27, 41, 42).[57] A case-by-case approach in this area, however, is not novel (see, *e.g.*, pp. 31-33 *supra*). It is compelled by the standard adopted by Congress ("substantially related" to exempt purpose); has been a fundamental principle of the regulations since 1958 (relatedness depends on "particular circumstances"); was augmented in the 1967 regulations (requiring a determination whether the activity "contributes importantly" and is "conducted on a larger scale than reasonably necessary"[58] and is required by Example 7 itself (*e.g.*, whether advertising has only an "incidental" informational function and is "designed and selected in the manner of ordinary commercial advertising").

The impact of the decision below (on revenues or audit resources) will be limited because few exempt organizations will be

56. An IRS special assistant for exempt-organization matters told a briefing sponsored by the American Association of Executives that this case was "a factually narrow dispute that is not of as much benefit to associations as they would like to think." *Inside ASAE*, Vol. 1, No. 18, p. 2 (March 22, 1985).

57. The government to the contrary, the court of appeals' decision does not require an "ad-by-ad" approach (Gov't Br. 7, 27, 41), since only if the organization can show that as a whole the advertising "contributes importantly" will further scrutiny be necessary. The government cites testimony by a witness in the House hearings to the effect that to draw the line "on an individual basis" would create an insurmountable audit burden for IRS (Gov't Br. 42). However, the witness was not IRS but a non-exempt publisher who favored a broad reading of the regulations, and it is not at all clear what type of line-drawing he meant. IRS has had no difficulty applying these or many other provisions of the Code and regulations on a case-by-case basis, and there is no reason to apprehend any particular new problems under the decision below.

58. The government argues that rejection of its *per se* rule would confer "immunity" from UBIT (Gov't Br. 29). However, the regulations make clear that if a related trade or business is "conducted on a larger scale than is reasonably necessary for performance of the exempt functions," then income attributable to the activities in excess of the needs of exempt functions may be taxable. §1.513-1(d)(3). No such issue arises in this case because, as the court of appeals noted, the government made no effort in this case to make such a showing (Pet. App. 19a-20a).

able to present as strong evidence linking advertising with their exempt purposes as did the College at trial. The specialized advertising in *Annals* is not merely "useful" or "educational" to internists, but contributes importantly to their ability to cure disease and improve the health care provided to their patients. Few ads will be as informational or "educational" as the prescription drug ads in *Annals*. Moreover, few organizations, given their purposes, really have a free choice between (c)(3) and (c)(6) designation, and the choice where present is dictated by numerous other considerations. The prospect of an influx of (c)(3) organizations seeking to take advantage of the decision below is fanciful, at best, particularly in view of the difficulty of satisfying the "contributes importantly" standard.

The government also contends that the court of appeals decision has "flouted" the "sharply defined legislative policy" concerning competition by exempt organizations (Gov't Br. 41, 43). However, Congress did not enact any legislative policy concerning competition apart from the provisions of section 513, which, as noted, makes exemption turn on relatedness without regard to competition (*see* p. 16 *supra*). The decision below faithfully applies the only legislative policy enacted by Congress in this area — section 513 — and is not inconsistent with any other discernible policies concerning competition.[59]

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59. As noted, the College set its advertising rates at levels comparable to those set by non-exempt publishers, and was not undercutting them (*see* p. 3 n.3 *supra*). Neither the government nor ABP has identified any anticompetitive or unfair aspect of the College's publication of advertising. Ironically, if the College followed the government's suggestion and included advertising "free of charge" (Gov't Br. 43) — a suggestion not endorsed by ABP — it might be charged with engaging in the ultimate form of predatory, unfair competition. In any event, the government's reliance upon the fact that advertisers are charged a fee (Govt. Br. 43) is misplaced, for it is a premise in every section 513 case that the activity generated income. Thus, that a fee was charged is irrelevant to whether the activity is "substantially related" *vel non*.

CONCLUSION

For the foregoing reasons, the decision of the Court of Appeals for the Federal Circuit in favor of respondent The American College of Physicians should be affirmed.[60]

Respectfully submitted,

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60. Because of the limited nature of the issue actually presented by this case, the writ of certiorari could appropriately be dismissed as having been improvidently granted.

Appendix A

Summary of Illustrative Examples Contained in Current Regulations Under Code Sections 511 through 514 (UBIT)

Regulation Section	Type of Organization
1.511-2(c)(2) Example	§501(c)(2)
1.512(a)-1(e) Example	Business league
1.512(a)-1(f)(2)(iii) Examples 1,2,3,4	Trade association
1.512(a)-1(f)(5) Examples 1 & 2	Scientific organization
Example 3	Trade association
1.512(a)-1(f)(7)(iii) Example	Trade association
1.512(a)-3(a)(2) Example	Social club
1.512(a)-3(b)(2)(ii) Example	Social club
1.512(a)-3(c)(2)(iv) Example	Social club
1.512(a)-3(c)(3)(iv) Example	Organization of fraternities
1.512(a)-3(c)(4) Example	Social club
1.512(a)-3(d)(2) Example	§501(c)(2) and social club
1.512(a)-3(d)(4) Example	§501(c)(2) and §501(c)(7)
1.512(a)-3(e)(8) Example	Social club
1.512(b)-1(c)(2)(iv) Example	Exempt organization
1.512(b)-1(c)(4) Examples 1,2,3,4	Exempt organization
1.512(b)-1(h)(2)(ii) Example	Association of churches
1.512(b)-1(i)(1)(ii) Example	Church under §1.511-2(a)(3)(ii)
1.512(b)-1(1)(2)(ii) Examples 1,2	Scientific organization under §501(c)(3)
1.512(b)-1(1)(3)(iii) Examples 1,2	University under §501(c)(3)
1.513-1(d)(4)(i)	
Example 1	§501(c)(3)
Example 2	§501(c)(5) trade union
Example 3	§501(c)(6) trade association
1.513-1(d)(4)(iv)	
Example 1	Scientific organization
Example 2	University
Example 3	Business league
Example 4	Musical organization
Example 5	University
Example 6	§501(c)(6)
Example 7	§501(c)(6)
1.513-3(c) Examples 1,2,3,4	§501(c)(6)
1.513-5(c)(3) Examples 1,2	Exempt organizations
Example 3	Veterans' organization

1.513-6(c) Example	Hospital
1.514(a)-1(a)(1)(iv) Example	Trade association
1.514(a)-1(a)(2)(iv) Example	Educational organization
1.514(a)-1(a)(3)(iii) Example 1	Educatational organization
Example 2	Exempt organization
1.514(a)-1(a)(4)(iv) Example	Trade association
1.514(a)-1(b)(4)(ii) Example	Educational organization
1.514(a)-1(b)(5)(ii) Example	Exempt organization
1.514(b)-1(b)(1)(iii) Example 1	Exempt organization
Examples 2,3	College
1.514(b)-1(b)(3) Example 1	Scientific organization
Example 2	Exempt organization
Example 3	University
1.514(b)-1(c)(2)(iii) Example 1	§501(c)(6)
Examples 2,3,4	§501(c)(5)
1.514(b)-1(c)(3)(ii) Example	§501(c)(3)
1.514(b)-1(d)(3)(i)(b)	
Examples 1,2,3,4	University
1.514(b)-1(d)(4)(ii) Example	Exempt organization
1.514(c)-1(a)(2) Example 1	Exempt organization
Example 2	Scientific organization
Example 3	Private school
Example 4	Exempt organization
1.514(b)-1(b)(3)(iv) Examples 1,2	§501(c)(3)
1.514(b)-1(e)(3) Example 1	Exempt organization
Example 2	University
1.514(d)-1(b)	Exempt trust